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DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency (Agency Name = OCC)
[Docket ID OCC–2007–0013]

Submitted 10/15/2007 by email to ***regs.comments@occ.treas.gov***
Fax 202-874–4448

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Board)
[Docket No. OP–1292]

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision (OTS)
[Docket ID OTS–2007–0016]

NATIONAL CREDIT UNION ADMINISTRATION (NCUA)

Collectively, the above are referred to as the Agencies.

Proposed Illustrations of Consumer Information for Subprime Mortgage Lending

I reviewed the Proposed Illustrations 1 and 2 from a consumer and business perspective and see shortcomings that are not addressed and that contribute to problems (defaults and predatory practices) in the subprime mortgage market.

Background

One issue is that originally ARMs were simply Adjustable Rate Mortgages. A borrower could opt for the ARM rather than a fixed rate, knowing the bank would have variable costs of funds from its depositors. Regulators wanted to get lenders to better match maturities of assets and liabilities.

Rather than have the bank buy the "insurance" to convert a variable rate to fixed, a sensible borrower could get a better rate for an ARM because the bank didn't have either that risk or that derivative cost. Simply stated, for a long time banks charged too much for fixed rates, possibly because they were meeting market demand for peace of mind or assurance of rate. If that was not true, that's the way it appeared to me.

Originally, ARMs that I observed used indices that were true market rates in the area of the real estate. U.S. Treasury-based rates were among the best.

That's the type of index implied by Illustration 2 with "an initial index of 5.5 percent".

But those ARMs were what I call symmetrical. They had an equal likelihood of going up or down in rate. That's what a consumer hears when he or she sees the term ARM and the words adjustable rate mortgage. They don't think a lender is playing a kind of con game where the deck is stacked or the dice are loaded.

What we have today, however, is asymmetrical. This is becoming pervasive, because it is in credit card lending as well as in subprime mortgages, and elsewhere.

I recommend that only symmetrical rate adjustment structures be allowed to be referred to as an ARM. I leave this to the Agencies to define and implement.

I would refer to any asymmetrical adjustable rate mortgage as a Biased Adjustable Rate Mortgage or B-ARM. This would serve several purposes. It would keep the well-known "ARM" acronym but quickly put all on notice (borrower, broker, attorney, lender) that this loan has greater likelihood of rising in rate than falling in rate (after any teaser period). I would put such terms in upper case bold to give additional disclosure.

Then, at some point, American banks and lenders started to use LIBOR as the index for United States based residential and other lending. I noticed this only in 2006 when I was preparing to make an offer on another home. I rejected LIBOR and chose a 15-year fixed rate.

But LIBOR become central to the current mortgage crisis.

Some brokers and even some bankers do not know all the variations of LIBOR. I heard a bank employee say the index was LIBOR and she didn't know the term, whether it was 3-month, 6-month, or 12-month LIBOR.

I didn't want LIBOR at all, or even the "Prime" Rate as my index, but I asked for details and learned more. Today I know that LIBOR is set with precision of 1/160th of a percentage point and is quoted to 5 decimal places. That is, a percentage and 5 decimal places such as 5.13750 in today's *Wall Street Journal* for the 6-month U.S. Dollar LIBOR. Bank of America then (in 2006) rounded up the index to the next 1/8 of a percentage point, and added the Margin. This rounding is sufficient, to me, to make this a biased calculation or biased adjustment. It was not clear if the LIBOR were a multiple of 1/8 percent such as 5.25000% if B of A would round up to 5.375% (I guess not, but one would have to read the fine print).

My point of this detail is that a loan proposal and loan document should specify the exact index, and not, for instance, just state "LIBOR". It should have the same precision as that index, such as 5 decimal places for LIBOR.

Illustration 1

My interest in a symmetrical presentation continues throughout Illustration 1. Rather than state "ARMs can be complicated", I start with "simple and clear" and then continue with the existing wording.

Following this document, I am filing another with 2 versions of Illustration 1. The first is your version. The second (running over to a 3rd page) shows my changes, with double strikethrough indicating deleted words and spaces, and underlines showing words and spaces added.

One of the most offensive provisions shown is one I saw first in May 2006. It is in your 3rd bullet item:

> **The amount of the penalty will be a percentage of the outstanding balance of the loan.**

I saw this exact wording even for a partial prepayment. My objection at the time was for documents for a $500,000 loan, and I wanted to be able to prepay $25,000 or multiples of $25,000 at any time, or I would reduce the amount of the loan. I objected to having to pay a 5% or $25,000 penalty if I prepaid $25,000. The lender flat out refused to make any wording changes. I rejected the loan.

It is preposterous to base a prepayment penalty on the "outstanding balance of the loan" rather than on the amount being prepaid.

This is similar in its anti-consumer, anti-borrower effects to the over-limit penalty charges for credit cards for which over-limit fees are based not on the amount over the limit but on the amount of the outstanding balance on the card.

The outstanding balance truly is irrelevant. The credit card companies implemented this policy to get what a deeper-pocketed consumer would bear. The "advance" is the amount over the limit. The result is that consumers get over-limit fees that can amount to 100% or more than the amount over the limit, even if paid down within days to under the credit limit – and this is after the card processor authorizes the transaction. All or almost all credit card companies, do not allow a consumer to specify that he wants the company to adhere to the line limit and reject a transaction that would cause an over-limit condition.

In both cases, credit card over-limit fees and prepayment penalties, the regulatory authorities should make sure that the charges relate to the "offense" or action that causes the fee, not some irrelevant condition or ability or even willingness to pay.

"Reduced documentation" Loans

"Reduced documentation" or "stated income" loans also could be structured to be much fairer.

Fair, Isaac & Company and all its followers pay inadequate attention to assets. A fair evaluation of a consumer's credit profile has to include assets as well as liabilities, but Fair Isaac doesn't even look at assets (such as in brokerage accounts). I would go further and state with a high degree of certainty that credit scores are statistically invalid. I wonder if the OCC or the Fed or Congress or any independent authority has provided evidence that they are valid.

The FICO logic is illogical. It seems to follow a path of if B causes A then A causes B.[1] I don't think so.

The Agencies should require that Fair Isaac and the CRAs who use credit scores demonstrate their statistical validity or modify them and demonstrate validity, or stop using them. This would be a multi-year process to phase them out, modify them or show that they are valid. There should be an open process to rebut their arguments of validity.

Regarding "Reduced documentation" or "stated income" loans, what I want is for a borrower to have time to correct a creditor error on a credit report or provide the documentation that is missing at the time the loan closes, or change from not paying taxes and insurance to paying them, making preset changes in the application of the formula to calculate the rate.

Borrowers who have "reduced documentation" may be able to provide the documentation in a few months or early in a 20- or 30-year loan and should not be saddled with the extra margin set at the loan closing based on what is available at that time. An adjustable- or variable-rate loan should be able to adjust for improved documentation, and lenders should be encouraged to offer them.

Illustration 2

Illustration 2 seems particularly anti-consumer.

I say this because the form is so biased to increases with no presentation of the "adjustable" feature that could cause a decrease. It's no excuse that there was too little room. Make it two-pages or even three if you need to display the loan terms fairly in a numerical manner. Yet the form is "entirely voluntary" and no one needs to use it or even a custom version of it.

It is more important here than the required pre-disclosure of basic terms for credit cards.

What I would like to see is a Principal and Interest Summary and a Historical Data Summary, from a spreadsheet analysis of any ARM loan proposal.

This would show the projected amount of principal repayment and the principal balance in 3, 5, and 10 (or more) years (perhaps ending at the date of the balloon).

[1] If they look at those who default and look back to see what debt characteristics they had, and they see some patterns, that does not mean that those who have those debt characteristics are equally (or even similarly) likely to default as those who do default.

I've done this for 6 types of mortgage parameters including the two samples in Illustration 2, and it is one way to show clearly the effect of the various parameters on each loan payment.

It could be compatible with the Payment Shock section on page 20 (PDF page 21) of the CHARM booklet.

Illustration 2 (and perhaps Illustration 1) should refer to the CHARM Booklet even though the lender may give that to the borrower when the loan documents are prepared for review and signature. The time to read it is at the earliest point when it can help a borrower make a choice. Showing online access to it would cost almost nothing for those who can download it.

The objective would be to give specific loan proposal information for someone who also gets the *Consumer Handbook on Adjustable-Rate Mortgages* (the CHARM Booklet). It should be enough information to evaluate a loan proposal and make a choice and a decision.

The CHARM booklet was recently modified so now it is 35 pages (up from about 10 plus a 2-page Mortgage Checklist – in mostly 5 point type – a couple of years ago).

In the tabular Illustration 2 I recommend displaying this data symmetrically.

1. For the Fixed Rate Mortgage show the rate to 2 or 3 decimal places, as 7.50% or 7.500%.

2. For each horizontal block, show the P and I, then the Escrow, and then the Total.

3. For Year 5 show the data (using the same number of decimal places to be used in the proposed loan) for

    - If the Index rate rises 2.000% [or use *increases* rather than *rises*]

    - If the Index rate falls 2.000% [or use *decreases* rather than *falls*]

If lenders or brokers do not have access to and skills to present the best disclosure, it is not necessary to exclude them from the marketplace. But it would be possible to let the public know that a first-class, approved format presentation is available to disclose and compare alternative financing approaches.

Thank you.

Sincerely,

Bernard E. Klein

Illustration 1

Important Facts About Your Adjustable Rate Mortgage

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an adjustable rate mortgage (ARM) is right for you. ARMs can be complicated. If you do not understand how they work, you should not sign any loan contracts, and you might want to consider other loans.

With an ARM, the interest rate on your loan is not fixed. Instead, it changes over time according to a formula – typically, a base interest rate (index) plus a certain percent (margin) (for example, the Prime Rate plus 3 percent). So, if the base interest rate increases, your interest rate and monthly payment will also increase.

Some specific terms of your ARM loan are explained below.

►Your loan will have a reduced initial interest rate.
Some ARMs have a reduced interest rate (start rate) for a short period of time – for example, the first two years of the loan. This rate is less than the index plus margin rate. This means that your interest rate and monthly payments will be lower than normal for the first two years. However, your interest rate and monthly payment may increase significantly when that period is over – even if market rates stay the same. And, your interest rate and monthly payment will increase even more if market rates rise.

►Your monthly payment will not include an amount to cover taxes and insurance.
In some mortgages, your monthly payment includes both principal and interest and an amount to cover real estate taxes and home insurance – and your lender pays your taxes and insurance out of these funds. In other mortgages, your monthly payment covers only principal and interest, and you are responsible for paying real estate taxes and insurance premiums when the bills arrive. When you are comparing mortgages, or deciding whether you can afford a mortgage, you need to consider whether or not the monthly payment includes an amount to cover estimated taxes and insurance.

►You will be required to pay a prepayment penalty if you pay off your loan more than 60 days before the initial interest rate is adjusted. The amount of the penalty will be a percentage of the outstanding balance of the loan.
Some ARMs require you to pay a large prepayment penalty if you sell your home or refinance during the first few years of the loan. A prepayment penalty can make it difficult, or very expensive, to sell your home or refinance – which you may need to do if your interest rate, and therefore your payment, is about to increase significantly.

►Your loan will have a balloon payment.
Most mortgages are set up so that you pay off the loan gradually by the monthly payments that you make over the loan term (for example, 30 years). Some ARMs, however, are set up with "balloon payments" – you make the same monthly payments that you would for a 30-year loan, but after a shorter period of time (for example, 10 years), the entire remaining balance of the loan is due. When the balloon payment is due you will usually need to refinance your loan to pay it, or sell your home if you cannot refinance the loan.

►Your loan will have a higher price because of reduced documentation.
"Reduced documentation" or "stated income" loans usually have higher interest rates or other costs compared to "full documentation" loans available if you document your income, assets, and liabilities. These higher costs can be substantial.

Illustration 1 (modified 10/15/2007)

Important Facts About Your Adjustable Rate Mortgage

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an adjustable rate mortgage (ARM) is right for you. ARMs can be simple and clear, or they can be complicated. If you do not understand all the features proposed to you and the risks and how they work for you, you should not sign any loan contract~~s~~, and you might want to consider another loan~~s~~.

With an ARM, the interest rate on your loan is not fixed. Instead, it changes over time according to a formula – typically, a base interest rate (index) plus a certain percent (margin) (for example, the Prime Rate plus 3 percent). So, if the base interest rate increases, your interest rate and monthly payment will also increase. After any initial rate lower than the formula rate, after the formula rate has been effective, your rate and payment (for principal and interest) can go up or down as the index goes up or down.

Some specific terms of your ARM loan are explained below.

►Your loan ~~will~~ may have a reduced initial interest rate.
Some ARMs have a reduced interest rate (start rate) for a short period of time – for example, the first two years of the loan. This rate is less than the formula of the index rate plus the margin rate. This means that your interest rate and monthly payments will be lower than normal for the first two years. However, your interest rate and monthly payment may increase significantly when that period is over – even if market rates stay the same. And, your interest rate and monthly payment may ~~will~~ increase even more if market rates rise or at the next rate reset date.

►Your monthly payment will not include an amount to cover taxes and insurance.
In some mortgages, your monthly payment includes both principal and interest and an amount to cover real estate taxes and home insurance – and your lender pays your taxes and insurance out of these funds. In other mortgages, your monthly payment covers only principal and interest, and you are responsible for paying real estate taxes and insurance premiums when the bills are due ~~arrive~~. When you are comparing mortgages, or deciding whether you can afford a mortgage, you need to consider ~~whether or not~~ the annual or monthly payments ~~includes an amount~~ needed to cover estimated taxes and insurance, whether or not they are part of the monthly mortgage payment.

►You will be required to pay a prepayment penalty if you pay off your loan more than 60 days before the initial interest rate is adjusted. The amount of the penalty will be a percentage of the outstanding balance of the loan.
Some ARMs require you to pay a ~~large~~ prepayment penalty if you sell your home or refinance during the first few years of the loan. A prepayment penalty can make it difficult, or very expensive, to sell your home or refinance – which you may ~~need~~ otherwise want to do if your interest rate, and therefore your payment, is about to increase significantly.

►Your loan will have a balloon payment.
Many ~~Most~~ mortgages (fixed rate and ARMs) are set up so that you pay off the loan gradually by the monthly payments that you make over the loan term (for example, over 20 or 30 years). Some ARMs~~,~~ ~~however,~~ are set up with a "balloon payment~~s~~" – you make the same monthly payments that you would for the term of the ~~a 30-year~~ loan, but after a shorter period of time (for example, ~~10~~ 7 years), the entire remaining balance of the loan is due. When the balloon payment is due, you will usually need to refinance your loan to pay ~~it~~ the balloon payment, or sell your home if you cannot refinance or otherwise pay off the loan.

►Your loan will have a higher price because of reduced documentation.
"Reduced documentation" or "stated income" loans usually have higher interest rates or other costs compared to "full documentation" loans available if you document your income, assets, and liabilities. These higher costs can be substantial. Discuss with your lender how you can meet all of the requirements for the best rate you qualify for.